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Letter Ruling 87-6: Stripped Bonds and Stripped Coupons from Massachusetts Tax-Exempt Securities

July 27, 1987

You ask about the Massachusetts income tax treatment of discount accruing to the purchasers of the Massachusetts series of _____ ("Certificates") described below.

_____ ("Sellers") will sell the Certificates in various series. Each series of Certificates will relate to a single issue of bonds issued by the Commonwealth of Massachusetts, its political subdivisions, or the agencies or instrumentalities of the Commonwealth, or its political subdivisions ("Massachusetts Tax-Exempt Securities"). Each series of certificates may include certificates ("coupon certificates") evidencing direct ownership of interest payments on the Massachusetts Tax-Exempt Securities ("stripped coupons"), certificates ("principal certificates") evidencing direct ownership of principal (and premium, if any) payments on the Massachusetts Tax-Exempt Securities ("stripped bonds"), and certificates ("annual pay certificates") evidencing direct ownership of principal (and premium, if any) payments and half the interest payments on the Massachusetts Tax-Exempt Securities (annual pay certificates are a combination of stripped bonds and stripped coupons).

The certificates will be sold in negotiated transactions at varying prices. Sellers will transfer the Massachusetts Tax-Exempt Securities to a custodian prior to or contemporaneously with the initial delivery of each series of Certificates. The custodian will apply all payments received in respect of the Massachusetts Tax-Exempt Securities to the payment of the Certificates to which they relate without making any deduction, other than any applicable tax withholding. The custodian is prohibited from asserting any rights and privileges of holders of the Certificates and will have no duty to do so by reason of its status as custodian of the Massachusetts Tax-Exempt Securities.

Owners of the Certificates will have all the rights and privileges of owners of the underlying interest and principal (with premium, if any) obligations. Owners of the Certificates have the right, in the event of default on the underlying interest or principal obligations, to proceed directly and individually against the issuer of the Massachusetts Tax-Exempt Securities, and will not be required to act in concert with other holders of Certificates or with the custodian. Any Certificate holder may exchange his Certificates for the underlying coupons and/or bonds.

For income tax purposes, Massachusetts gross income, under G.L. c. 62 is federal gross income as defined under the Internal Revenue Code as amended on January 1, 1985 and in effect for the taxable year, with certain modifications. Federal gross income "does not include interest on the obligations of a State...or any political subdivision of the foregoing." I.R.C. § 103. To arrive at Massachusetts gross income, interest from state obligations other than interest on obligations "issued by the commonwealth, any political subdivision thereof, or any agency or instrumentality of either of the foregoing, which is exempt from taxation under clause Twenty-five of section five of chapter fifty-nine or any other provision of the law," is added to federal gross income and is included in Massachusetts gross income. G.L. c. 62 § 2(a)(1)(A).

You have represented that the bonds to which the certificates relate are "governmental obligations

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excluded under section one hundred and three of the Code" and are "obligation[s] issued by the Commonwealth, any political subdivision thereof, or any agency or instrumentality of either of the foregoing, which is exempt from taxation under clause twenty-fifth of section five of chapter fifty-nine or any other provision of law." G.L. c.62, § 2(a)(1)(A). We express no opinion as to the tax-exempt nature of the underlying obligations, and this ruling is applicable only if the "Massachusetts Tax-Exempt Securities" are obligations that are excluded from the Massachusetts gross income by G.L. c. 62, § 2(a)(1)(A). Furthermore, you have represented that no separate taxable entity is created by the custody agreement, that no trust exists, and that under Massachusetts and federal law the certificate holders are the direct owners of the stripped bonds and stripped coupons. We express no opinion whether a separate entity is created or whether the character of the income to the limited to the custodian passes through to the certificate holders. Rather, this ruling is limited to the question of whether the stripping of coupons from an obligation that would produce income exempt from the Massachusetts taxation under G.L. c. 62 will cause the income from the stripped coupon and stripped bond to be recharacterized as taxable income under G.L. c. 62.

Original issue discount on tax exempt obligations is not included in federal gross income. I.R.C. (1985) § 1272. If the underlying obligation is a taxable obligation, the amount of original issue discount on stripped bonds and stripped coupons is computed under I.R.C. (1985), § 1286(a). This section, however, does not apply to tax-exempt obligations. I.R.C. (1985), § 1286(d). The Internal Revenue Code as amended on January 1, 1985 does not provide specific rules for the treatment of discount on stripped bonds and stripped coupons from tax-exempt obligations.

We rule that, for purposes of this transaction, we will follow the approach that has been adopted by the Tax Reform Act of 1986, P.L. 99-514, § 1879(s) (1986) for the treatment of discount accruing on the Certificates. For Massachusetts purposes, the stripped bonds and the stripped coupons from the Massachusetts Tax-Exempt Securities shall be treated as bonds originally issued on the purchase date and having original issue discount in an amount which produces a yield to maturity (as of the purchase date) of the stripped obligation or stripped coupon or (B) the coupon rate of interest on the Massachusetts tax-exempt obligation. The original issue discount, as determined by this ruling, shall be interest from a Massachusetts tax-exempt obligation; and such original issue discount shall not be included in Massachusetts gross income under G.L. c. 62.

Very truly yours,
/s/ Thomas D. Herman
First Deputy Commissioner
July 27, 1987
LR 87-6